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No. 87-1166

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

DONALD E. CLARK AND PEGGY S. CLARK,
Respondents.

On Writ of Certiorari to the
United States Court of Appeals
for the Fourth Circuit

BRIEF FOR THE RESPONDENTS

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QUESTION PRESENTED

When Mr. Clark's company was acquired, by a publicly held company, in a tax-free reorganization, Mr. Clark received 300,000 shares of common stock and chose to receive cash instead of 125,000 additional shares of the acquiring company's stock. The question presented is whether, under section 356(a)(2) of the Internal Revenue Code, the cash Mr. Clark received in lieu of additional stock should have been taxed as a capital gain or as a dividend.

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OCTOBER TERM, 1987

No. 87-1168

COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

DONALD E. CLARK AND PEGGY S. CLARK

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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BRIEF FOR THE RESPONDENTS

STATEMENT

Donald Clark, the respondent,[1] was the sole shareholder of Basin Surveys, Inc. ("Basin"), a West Virginia corporation engaged in the business of providing technical services to the petroleum industry. J.A. 26, 33. In 1978, N.L. Industries ("NL"), a publicly held company with extensive petroleum service operations, initiated negotiations with Mr. Clark over the possible acquisition of Basin.

In the final negotiating session, in March 1979, NL offered Mr. Clark alternative forms of consideration in con-

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[1] Mr. Clark's wife, Peggy S. Clark, is a party solely because she filed a joint return with her husband for the year in question.

nection with the proposed acquisition of Basin by merger: Mr. Clark had a choice of receiving (1) 425,000 shares of NL common stock, or (2) 300,000 shares of NL common stock and, instead of the additional 125,000 shares, $3.25 million in cash. Pet. App. 2a, 6a. After considering the alternative proposals, Mr. Clark decided to accept the offer which provided him with cash in lieu of the additional shares of stock.[2] J.A. 57. In April 1979, the acquisition was effected through a merger of Basin into a newly formed subsidiary of NL and, as a step in the merger, Mr. Clark received the agreed-upon consideration. Pet. App. 17a.

As a result of Mr. Clark's acceptance of the combined stock and cash offer, the total number of NL common shares outstanding increased to approximately 32,833,000 shares, and Mr. Clark's stockholdings represented approximately 0.92 percent of that total. If Mr. Clark had accepted the all-stock offer of 425,000 shares, the total number of NL common shares outstanding would have increased to approximately 32,958,000 shares, and Mr. Clark's stockholdings would have represented approximately 1.3 percent of that total. Pet. App. 16a. Mr. Clark's 300,000 share ownership of NL after the transaction was 70.6 percent of the 425,000 shares he would have owned had he taken the all-stock offer.

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[2] In the Tax Court, Mr. Clark's attorney, who participated in the negotiations, testified that Mr. Clark originally sought NL stock as the sole consideration for his Basin stock. J.A. 57. Also at trial, the NL negotiator testified that NL was prepared to go forward with the transaction on the basis of either alternative; that it did not know which offer Mr. Clark would accept; that its preference was to pay Mr. Clark a portion of the consideration in cash as a means of reducing the number of shares of NL stock that would be outstanding after the acquisition; and that the amount of cash offered to Mr. Clark was based on NL's determination of the value of the additional 125,000 shares that it would have had to issue to Mr. Clark in the all-stock proposal. J.A. 46-48. This testimony was accepted as true by the Tax Court. Pet. App., 37a.

The transaction qualified as a "reorganization" under section 368(a)(1)(A) and (a)(2)(D) of the Internal Revenue Code of 1954.[3] Pet. App. 16a-17a. Under section 356(a)(1), Mr. Clark was required to pay tax on the $3.25 million cash or "boot" payment to the extent of his gain on the transaction with NL. Since Mr. Clark's gain (after taking into account the cash and market value of the NL stock he received in exchange for his Basin stock) exceeded the amount of cash received, Mr. Clark reported the entire cash payment as gain, taxable at long term capital gain rates under section 356(a)(2).[4] On audit, the IRS determined that the cash received by Mr. Clark had "the effect of a distribution of a dividend" under section 356(a)(2) and was, therefore, taxable as a dividend.[5] Because dividends are taxable at ordinary income rates, while, in 1979, capital gains were taxed at only 40 percent of ordinary rates, this determination resulted in an asserted deficiency of $972,504.74 in federal income taxes for 1979.

Mr. Clark petitioned the Tax Court for review of the IRS determination. A trial was held in the Tax Court at which Mr. Clark, the NL official who represented NL in the acquisition, and Mr. Clark's attorney provided testimony on the negotiations between the parties. The Tax Court, in a reviewed decision with no dissents among the fifteen participating judges, held in favor of Mr. Clark. Pet. App. 15a-39a.

The Fourth Circuit affirmed, with no dissents. Pet. App. 1a-14a. It rejected petitioner's "hypothetical" view of the

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[3] All statutory references are to the Internal Revenue Code of 1954, 26 U.S.C., as in effect for the year 1979, unless otherwise specified.

[4] Because of a computational error, the amount of gain actually reported on the return was $3,195,294. In the later computation for entry of decision by the Tax Court, Mr. Clark stipulated that the amount of gain recognized and reported should have been $3,250,000. J.A. 66.

[5] Pursuant to section 356(a)(2), the amount claimed to be taxable as a dividend is $2,319,611, the stipulated amount of the accumulated earnings and profits of Basin on the acquisition date. J.A. 29.

transaction (Pet. App. 8a), "characterizing [the boot] as a dividend paid by Mr. Clark's company immediately before the reorganization." Pet. App. 1a. That characterization, the court of appeals held, "fails to recognize that the cash was an integral part of a reorganization." *Id.* 1a-2a. Considering the receipt of cash as part of "the transaction in its entirety," the court held, it was properly regarded as "a cash payment by N.L. in return for Mr. Clark's relinquishment of a portion of his interest in the newly reorganized corporation." *Id.* 2a. Since the reduction exceeded the 20 percent threshold of section 302(b)(2), Mr. Clark was, the court found, entitled to capital gain treatment.

SUMMARY OF ARGUMENT

In 1979, Basin, the company then owned by respondent, Mr. Clark, was acquired by NL, a large publicly held company, in a transaction that qualified as a "reorganization" under section 368 of the Internal Revenue Code. NL offered Mr. Clark a choice between receiving, for his Basin stock, either 425,000 shares of NL stock or 300,000 shares and $3.25 million in cash. Mr. Clark chose the latter option. As a result of the exchange, therefore, Mr. Clark received cash plus an ownership interest in NL which was reduced by some 30 percent to reflect the cash payment.

The sole issue in this case is whether the court of appeals was correct in holding that the $3.25 million that Mr. Clark received was properly treated as all capital gain, because receiving the cash had the effect of substantially reducing his interest in the continuing enterprise that emerged from the reorganization. By contrast, petitioner contends that the distribution of the cash should be viewed in isolation, as if it had been paid by Basin as a dividend before, and independent of, the reorganization, and taxed as ordinary income, to the extent of the earnings and profits of Basin. That the court of appeals was correct follows from basic tax principles and from the reality of the situation.

When, in a transaction qualifying as a "reorganization", the shareholders of the acquired corporation receive cash (or other consideration besides stock of the acquiring corporation), the tax treatment of that "boot" is governed by section 356. Section 356(a)(1) makes the boot taxable up to the amount of gain on the transaction. Section 356(a)(2) governs the character of the income: the boot is taxable as capital gain, unless the exchange of the stock for cash and stock "has the effect of the distribution of a dividend."

The court of appeals, following the analysis previously adopted in *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973), held that whether the exchange had the "effect of a dividend" must be measured by reference to the effect of the exchange in which the cash was received on Mr. Clark's continuing interest in the reorganized NL-plus-Basin corporation. The integrated approach thus employed by the court below is supported by basic tax principles, while the artificially bifurcated approach of the petitioner violates them.

This Court has held that the hallmark of a non-dividend distribution is a "meaningful reduction of the shareholder's proportionate interest in the corporation." *United States v. Davis*, 397 U.S. 301, 313 (1970). It is a basic principle of tax law that in a reorganization there is both a continuation of the pre-transaction businesses and a continuity of ownership of those businesses. *Paulsen v. Commissioner*, 469 U.S. 131 (1985). Accordingly, the "effect" of the exchange here, and specifically whether it resulted in a "meaningful reduction" in Mr. Clark's shareholder interest, must be measured by the effect of his receipt of cash on his interest in the continuing enterprise. By that standard, there was no dividend, for the receipt of cash reduced his continuing ownership interest by some 30 percent, clearly enough to preclude dividend treatment.

The petitioner's view—that the cash should be treated as a separate pro rata distribution to Mr. Clark, independent of the overall reorganization of which it was a part—is not only inconsistent with the continuity principles of reorganizations. It also ignores the "step transaction" doctrine whereby, rather than giving separate consideration to each of the various steps which make up an integrated transaction, they are viewed together to determine their tax effect. *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945). The court below applied this basic principle of federal income taxation; the petitioner's approach exemplifies just the artificial fragmentation that the step transaction doctrine was created to prevent.

Further, in measuring the significance of the diminution of Mr. Clark's interest in NL, it was proper for the court of appeals to apply the principles of section 302, dealing with the treatment of corporate distributions as dividends or redemptions. Section 302 treats a distribution in redemption of stock as an exchange, with the gain eligible for capital gain treatment, unless the distribution is "essentially equivalent to a dividend," and it establishes detailed rules for determining that equivalence. Because of the similarities in the terms and objectives of section 302 and section 356, and because of the desirability of a common standard in the area, the reliance on section 302 standards here was reasonable and correct. The relevance of the section 302 standards to section 356(a)(2) has been acknowledged by other courts, the Internal Revenue Service, and, most importantly, by Congress.

Indeed, the approach of the courts below—both in taking an integrated approach and in looking to section 302 for guidance—has been broadly endorsed by commentators and recommended for statutory codification by the American Bar Association and the staff of the Senate Finance Committee. It has, in fact, been pronounced "acceptable" by the tax policy authorities at the Treasury Department, in

the context of the pending revision of the corporate reorganization provisions of the Internal Revenue Code.

By contrast, petitioner's insistence that the cash portion of the transaction be viewed only with reference to Mr. Clark's ownership of Basin (and, hence, be viewed as a "pro rata" distribution) ignores the facts, as well as these basic tax principles. Petitioner's view would resurrect an automatic dividend rule, and would be subject to manipulation and abuse. Moreover, the legislative history of section 356(a)(2), as well as this Court's decision in *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945), which dealt only with a single corporation recapitalization, do not lend any support to petitioner's position. Nor does the claimed "long and consistent line of court of appeals cases" truly exist. Of the post *Bedford* cases, only *Wright*, supra—whose analysis was adopted by the court of appeals here—and *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978)—which follows the unrealistic bifurcation approach urged by petitioner—discuss the issues presented here in any systematic way. The integrated analysis of the court of appeals, which was also employed by *Wright* and has been broadly accepted by expert observers, offers the correct solution to measuring whether, in an acquisitive reorganization such as occurred here, an exchange involving boot had the effect of a dividend.

ARGUMENT

I. THE COURTS BELOW CORRECTLY DETERMINED THAT THE EXCHANGE IN WHICH MR. CLARK RECEIVED CASH FROM NL DID NOT HAVE THE EFFECT OF A DIVIDEND.

The question presented by this case involves fundamental principles underlying the reorganization provisions of the Internal Revenue Code. Under those provisions, an acquisition of one corporation by another in a transaction that qualifies as a reorganization is accorded non-recog-

nition treatment to the extent that the shareholders of the acquired corporation exchange their stock for stock in the acquiring corporation. If the shareholders also receive cash for their stock, the cash is taxable up to the amount of gain on the exchange. And, the taxable amount is treated as a capital gain, unless the "exchange" of stock for cash and stock "has the effect of the distribution of a dividend." Section 356(a)(2).

The issue raised here is whether Mr. Clark's exchange of Basin stock for NL stock plus cash should be taxed at capital gains rates or as a dividend. Both the Tax Court and the court of appeals were unanimously of the view that dividend effect should be measured by treating the reorganization—*i.e.*, the merger of Basin into NL and the exchange of Basin stock for NL stock and cash—as an integrated transaction. The focal point of the inquiry by the courts was therefore the effect of the entire *exchange* on Mr. Clark's *continuing interest* in the reorganized corporation—not, as petitioner maintains, the effect of the *cash* in isolation on Mr. Clark's *former* interest in the absorbed corporation. In measuring that effect, the courts below applied the principles of section 302, which contains standards for differentiating cash distributions treated as dividends from cash distributions treated as payments in exchange for stock.

The approach taken by the courts below is in accord with basic principles, expressed by this Court, underlying the reorganization and dividend provisions of the Internal Revenue Code. It is also supported by a substantial body of authority, including the decision of the Eighth Circuit in *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973), the opinions and analyses of leading scholars and commentators, the intent of Congress expressed in connection with a recent clarifying amendment to the statutory provision in issue, and the policy views of the Treasury Department.

A. The Test of a Dividend is Effect on Post-Payment Ownership.

The fundamental issue here is whether the realistic, integrated view of the transaction taken by the Fourth Circuit was correct. That it was correct follows from holdings of this Court and from basic tax principles.

1. There Is No Dividend When There Is a "Meaningful Reduction" in Ownership Interest.

Under section 356(a)(2), a transfer of stock and cash to shareholders participating in a reorganization must have the "effect of a distribution of a dividend" for ordinary income treatment to be required. This Court has, in *United States v. Davis*, 397 U.S. 301 (1970), defined a dividend as a distribution to a shareholder "without a change in the relative economic interests or rights of the shareholder." 379 U.S. at 313. In contrast, it has said that if receiving cash results in a "meaningful reduction of the shareholder's proportionate interest in the corporation," the transaction is not a dividend distribution. *Id.* In the latter situation the shareholder is considered to have sold a portion of his equity interest to the corporation for cash, resulting in exchange rather than dividend treatment.

In determining whether Mr. Clark's choice of the part-stock, part-cash offer "had the effect of a dividend" the determining factor is, therefore, whether it produced a "meaningful reduction" in his "relative economic interest" as a shareholder.

2. "Meaningful Reduction" Must Be Measured With Reference to Reorganized, Continuing Enterprise.

When, as here, cash is received as part of an exchange in a merger that simultaneously transforms the entity in which the ownership interest is held, the effect of the cash can be measured meaningfully only by considering the effect of the exchange in the

context of the transaction *as a whole*, as the courts below did, not as if the cash had been received in isolation, as the petitioner would have this Court do.

a. A Reorganization Results in a Continuing Enterprise With Continuing Ownership Interest.

The acquisition of Basin by NL constituted an "A reorganization" under section 368(a)(1)(A) and (c)(2)(D). The need to measure dividend effect in the context of the whole reorganization transaction follows from the nature of tax-free reorganizations.

It is a basic concept underlying the special treatment of "reorganizations" under the federal income tax law that the entity which emerges from the reorganization is a continuation, in modified corporate form, of the business enterprises that participated in the reorganization. Indeed, one of the fundamental requirements for reorganization treatment of an acquisition is that the shareholders of the acquired corporation receive in the transaction a sufficient ownership interest in the surviving entity to establish a "continuity of proprietary interest."[6] When that standard is met in an acquisitive reorganization, such as occurred here, the shareholders of the acquired corporation are considered to have continued their investments in the acquired corporation by virtue of the ownership interests which they receive and retain in the enlarged, surviving entity.

This concept of continuing ownership in a continuing entity applies equally where, as here, there is a great disparity in the size of the parties to the reorganization: When Basin was absorbed, the slightly enlarged NL that emerged from the reorganization was the continuation not only of NL's prior business, but also of Basin's. Indeed,

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[6] *See, generally*, Treas. Reg. § 1.368-1(b); *Paulsen v. Commissioner*, 469 U.S. 131 (1985); *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951).

NL's purpose in making the acquisition was to be able to continue Basin's business. J.A. 44. Similarly, the continuity of proprietary interest doctrine means that for tax purposes, Mr. Clark's ownership interest in Basin did not terminate. Rather it continued uninterrupted in his ownership interest in the new, enlarged NL, just as the NL stockholders' prior ownership in NL alone continued in the enlarged, new enterprise which absorbed Basin's business activities.

b. The Character of Taxable Boot Depends on the Effect of Its Distribution As Part of the Reorganization Exchange.

The tax-free treatment afforded reorganizations—and the special limitations on that treatment at issue here—follow from this basic proposition that a reorganization involves a continuing enterprise in which ownership continues as well. Specifically, in a qualifying reorganization, gain is—contrary to the general rule of section 1001(c)—not recognized by the shareholders of the corporations involved even though the business represented by their stock has, in a merger, been transformed and enlarged. This tax-free treatment is accorded because a reorganization transaction is "deemed insufficiently closed economically to justify a tax at the time, except insofar as the stockholder gets something in addition to stock or securities in the reorganized company." *Lewis v. Commissioner*, 176 F.2d 646, 648 (1st Cir. 1949). *See also Paulsen v. Commissioner*, 469 U.S. 131, 136 (adopting description of a reorganization as "recasting the same interests in a different form").

Consistent with these principles, no gain is recognized where only stock or securities are received in a reorganization. Section 354(a)(1). However, in reorganizations in which the shareholders of the acquired corporation also receive cash or other non-stock consideration—commonly called "boot"—in the reorganization, a special statutory

rule applies to govern the tax consequences of receiving the boot. This rule (section 356(a)(1)) provides that if the shareholders of the acquired corporation receive cash or other property in addition to stock or securities, they must recognize gain on the transaction up to the amount or fair market value of the boot.

Mr. Clark has, pursuant to this provision, paid tax on the full amount of the cash boot he received. The sole issue in this case is the *character* of the income—capital gain or ordinary income—that Mr. Clark recognized pursuant to section 356(a)(1).

Section 356(a)(2) governs the characterization of the amount of income required to be recognized by section 356(a)(1). That characterization rule provides for dividend treatment as a possible, not as a certain, result of receipt of boot. Of course, a straight sale of stock for cash generally results in capital gain treatment, and, consistent with that, section 356(a)(2) declares that only if the exchange involving the receipt of stock plus boot "has the effect of the distribution of a dividend" to the distributee shareholder must the boot be treated as a dividend, taxed at ordinary income rather than capital gain rates.[7]

c. The Effect of a Boot Distribution Must be Measured by the Effect of the Exchange on Continuing Ownership Interest.

In accordance with this Court's definition of a dividend and with the basic principles of the reorganization provisions, the question posed by section 356(a)(2) must be addressed, as the courts below did here, with reference to the shareholders' continuing interest in the surviving corporation.

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[7] Under section 356(a)(2), the amount treated as a dividend is limited to the distributee shareholder's ratable share of accumulated earnings and profits of the corporation.

As noted above, the factor that distinguishes a dividend distribution from a distribution in exchange for stock is that in the latter case, as consideration for the distribution, there is a corresponding, "meaningful" reduction in the shareholder's equity interest—*i.e.*, in the shareholder's voting rights, right to participate in future earnings, and right to share in liquidation proceeds. *United States v. Davis*, *supra*; *see also Wright v. United States*, *supra*, at 607-08. Moreover, the basic assumption of a tax-free reorganization is that the shareholder's investment has not terminated, but rather continues in the reorganized, surviving entity. Both of these concepts dictate that the dividend effect of an exchange including boot be measured from the standpoint of the shareholder's equity interest in the entity that survives the reorganization and continues to be engaged in business, not with reference to his former, now vanished, ownership in the acquired corporation, which ceases to exist as a separate entity with the reorganization.

Moreover, the language of section 356(a)(2) suggests this result. It speaks in terms of the possible dividend effect of the *exchange*, not simply the dividend effect, in isolation, of the cash. To measure the effect of the *exchange*, it is necessary to consider the overall transaction and determine whether the shareholders experienced a meaningful reduction in their interest in the reorganized entity that emerges from the exchange.

So determined, there was clearly no dividend here. The undisputed consequence of the exchange by Mr. Clark of Basin stock for NL stock plus cash was that Mr. Clark had a significantly smaller ownership interest in the continuing enterprise—by some 30 percent—than he would otherwise have had if the exchange had involved entirely NL stock.[8] In the court of appeals' words, the effect of

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[8] As discussed in more detail below, pp. 18-22, in determining whether the reduction in Mr. Clark's interest was sufficiently substantial to be

the distribution was Mr. Clark's "relinquishment of a portion of his interest in the newly reorganized corporation." Pet. App. 2a. Such an effect is inconsistent with that of a dividend.[9] On the record in this case, there is, therefore, not the slightest doubt that receipt of the cash produced just that practical effect of reducing Mr. Clark's continuing ownership interest that under *Davis* unequivocally distinguishes it from a dividend.

3. The Step Transaction Doctrine Requires Applying the Dividend Equivalency Test at the Surviving Corporation Level.

Equally important, the approach of the courts below reflects a correct application of the step-transaction doctrine, while the petitioner's approach here would simply

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inconsistent with dividend treatment, the courts below properly looked to the detailed standards of section 302. On any reasonable basis, however, a 30 percent reduction in the interest of a minority stockholder is economically significant and inconsistent with dividend status. See *e.g.*, Rev. Rul. 76-364, 1976-2 C.B. 91 (17.5% reduction is meaningful); Rev. Rul. 76-385, 1976-2 C.B. 92 (3.3% reduction in interest of small minority shareholder is meaningful). Evidently, the petitioner does not dispute that if the transaction is to be analyzed by comparing Mr. Clark's actual ownership in the continuing NL-plus-Basin enterprise with what he would have had absent the boot, the reduction is sufficient to make capital gain treatment appropriate. *Cf.* Pet. App. 35a.

[9] Petitioner suggests (Br. 37) that even if the exchange had the effect of a nondividend transaction (*i.e.*, a disproportionate redemption) it could still also have the "effect of a dividend" within the meaning of section 356(a)(2). The fatal difficulty with this is that a dividend and the redemption transaction to which the court of appeals properly analogized the exchange are mutually inconsistent in their effects. The courts below found that in economic effect, the boot meaningfully reduced Mr. Clark's continuing relative interest in the continuing enterprise. Since this Court has held that it is the absence of such an effect on relative interests that is the distinguishing feature of a dividend, that conclusion logically excludes the transaction having the effect of a dividend.

ignore this basic principle of tax analysis.[10] The step-transaction doctrine is a well established principle of tax law, used (indeed, embraced) more often as a sword by the petitioner than as a shield by taxpayers. Under this doctrine, rather than giving separate consideration to each of the various steps which comprise an integrated transaction, the steps are viewed together in light of the overall transaction to determine their tax effect. *See, e.g., Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938); *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945); *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954).[11] Indeed, the IRS routinely uses the step transaction doctrine to analyze the tax effects of transactions similar to the NL-Basin merger. *See* Rev. Rul. 75-447, 1975-2 C.B. 113; Rev. Rul. 75-360, 1975-2 C.B. 110.[12]

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[10] Nowhere in the petitioner's brief is this basic doctrine even mentioned.

[11] The situation in *Zenz v. Quinlivan* is particularly instructive here. In *Zenz*, the taxpayer wished to sell all of her stock in a corporation in which she was the sole shareholder. To satisfy the objective of the purchaser (who did not want to buy all the stock) the parties agreed upon a plan under which the purchaser bought part of the stock and the corporation redeemed the remaining shares. The court viewed the steps in the transaction as part of an integrated plan intended to terminate the taxpayer's holdings in the corporation. As a result, the redemption was held not essentially equivalent to a dividend because, *taken together with the sale*, the redemption completely terminated the shareholder's interest in the corporation.

[12] In Rev. Rul. 75-447, the IRS approved the *Zenz* result and extended it to situations where, as part of a plan, a corporation redeems some stock of existing shareholders and issues stock to a new shareholder. According to the ruling, "in situations where the redemption is accompanied by an issuance of new stock . . . or a sale of stock . . . *and both steps (the sale, or issuance, of stock, as the case may be, and the redemption) are clearly part of an integrated plan to reduce a shareholder's interest*, effect will be given only to the overall result for purposes of section 302(b)(2) and the sequence in which the events occur will be disregarded." (emphasis added)

The approach taken by the Tax Court and the court of appeals is fully consistent with the step transaction doctrine. Pet. App. 13-14a. It focuses on the overall transaction and treats the boot, taken together with the transfer of NL stock to Mr. Clark, as what it in fact was—a payment in consideration for Mr. Clark's acceptance of a lesser interest in the continuing NL enterprise which emerged from the reorganization. Petitioner, on the other hand, attempts to bifurcate the transaction and treat the boot as if it were distributed by Basin prior to the merger, followed by an entirely unrelated transfer of NL stock to Mr. Clark in connection with the merger of Basin into NL. It is just such artificial fragmentation of integrated transactions that the step transaction doctrine was created to prevent.

4. The Economic Substance and Factual Record of the Present Transaction Strongly Support Measuring Dividend Equivalency By the Exchange's Effect on Ownership in the Surviving Corporation.

In the present case, the facts strongly support the approach taken by the courts below. Mr. Clark's acceptance of less NL stock as the consequence of taking the cash was far from notional; it was a real and conscious choice. At trial, the participants testified in detail to the events leading up to this choice. The Tax Court found the facts as follows: At the culmination of negotiations for the acquisition of taxpayer's corporation, NL's representatives offered Mr. Clark a choice: In exchange for Mr. Clark's stock in Basin, NL was willing to give him either (1) 425,000 shares of NL common stock and no cash, or (2) a combination of 300,000 shares of common stock and $3,250,000 cash. Pet. App. 16a. The initiative for the cash offer came from NL, not Mr. Clark, and it was based on NL's desire to minimize the number of shares outstanding. Pet. App. 37a. The net effect of Mr. Clark's accepting the combined stock and cash offer was therefore that his per-

centage ownership in the surviving, continuing entity after the reorganization was reduced to barely 70 percent of what it would have been had he received all-stock.[13]

The Tax Court also noted additional economic circumstances of the transaction that confirm the correctness of its conclusion that the transaction did not have the effect of a dividend under section 356(a)(2). These included the lack of "the slightest evidence of a concealed distribution" from Basin, and Basin's lack of practical ability to make such a payment, since it exceeded not only its cash and accumulated earnings, but its total assets. Pet. App. 37a.

These facts highlight the realism of the approach used by the courts below and the artificiality of the petitioner's approach in viewing the transaction as an independent distribution by Basin.[14]

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[13] Mr Clark took the cash because he saw the offer as an opportunity to liquidate part of his stock interests, for which he would otherwise have had to wait until restrictions on transfer of the NL stock expired. J.A. 58. Contrary to petitioner's implications (Br. 33-34) these motives are the concerns of a person focusing on the wisdom of committing so much of his capital to NL stock as the all-stock offer entailed, not of a person seeking to bail out earnings of Basin.

[14] Petitioner's contention (Br. 33, citing *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974)) that the integrated approach effectively repudiates the form chosen for the transaction is misdirected. In form, as well as in substance, the effect of the exchange was that Mr. Clark received cash plus a smaller interest in NL. The cash came from NL not Basin; the initiative for offering the cash came from NL's acquisition negotiator, not from Mr. Clark as a final act as controlling shareholder of Basin; and the cash reduced Mr. Clark's continuing ownership by a precisely measurable and meaningful amount. The all-stock alternative is relevant precisely because it did *not* happen and because the effect of taking the stock-plus-cash option and not following that other course was to change Mr. Clark's relative economic interest.

B. The Courts Below Properly Looked to Section 302 in Applying the Dividend Equivalency Test at the Surviving Corporation Level.

The courts below held that the effect of the cash on Mr. Clark's relative ownership interest should be tested under the principles of section 302, which governs redemptions, to determine whether in receiving the cash "Clark yielded a sufficient portion of his corporate control" to be entitled to capital gain treatment.[15] Pet. App. 5a. Therefore, they compared, using the standards of section 302(b)(2), Mr. Clark's percentage interest in the surviving, enlarged NL-plus-Basin business with the percentage interest in that business that Mr. Clark would have obtained without the cash distribution, under the all-stock alternative.

1. Section 302(b) Is an Appropriate Guide Because It Is Concerned With the Same Issues as Section 356(a)(2).

Section 302, dealing with the tax effects of redemptions of stock, is relevant to section 356(a)(2) because it contains similar language and addresses a similar issue. Section 302 treats cash received in a redemption as a dividend if the distribution is "essentially equivalent to a dividend." Section 302(b)(1). This language is very close in phrasing, and identical in substance, to section 356(a)(2)'s standard of whether a boot distribution has "the effect of a dividend." In addition, the purposes of the two sections are con-

[15] Contrary to the petitioner's claim (Br. 28) what he characterizes as the court of appeals' "abstract" discussion of the applicability of section 302 was not the foundation of its analysis; nor did it fail to "directly examine the merger transaction." Br. 27. Rather, the court of appeals recognized (Pet. App. 7a) that the critical question was not whether section 302 applied, but whether to take an integrated view of the transaction under section 356(a)(2), and it proceeded to analyze that issue in detail. Thus, application of section 302, although it is entirely appropriate, is not essential to the logic or correctness of the holding below.

gruent—both serve to differentiate between distributions which should be viewed as payments in exchange for stock and distributions which should be treated as dividends. Finally, section 302, in contrast to the spareness of section 356(a)(2), provides elaborate definitions of when the dividend equivalence test is met. Separate definitions for the functionally similar cases of section 302 (redemptions) and section 356 (reorganizations) would not only be confusing; they would create unnecessary and dysfunctional distortions in tax treatment depending upon the form of the transaction.

2. The Section 302 Analysis Employed By the Court of Appeals Has Been Widely Accepted.

In applying both the redemption analogy and the dividend effect standards of section 302 to this section 356(a)(2) problem, the courts below were not only following the logic of the statute, but the weight of authority. That approach has been approved also by other courts, by the Internal Revenue Service, by the Tax Division of the Justice Department, and by Congress.

The courts have stated that the two sections are to be read *in pari materia*. *See Wright v. United States*, *supra*, at 605; *King Enterprises, Inc. v. United States*, 418 F.2d 511, 520-21 (Ct. Cl. 1969); *Ross v. United States*, 173 F. Supp. 793, 797, (Ct. Cl. 1959), *cert. denied*, 361 U.S. 875 (1959); *Hawkinson v. Commissioner*, 235 F.2d 747, 751 (2d

Cir. 1956). The Internal Revenue Service has also adopted this position in published rulings[16] and in its litigating position.[17]

More importantly, Congress, as well, has affirmed the correctness of this position in connection with a recent amendment to section 356(a)(2). The Conference Committee Report for the Deficit Reduction Act of 1984, which made changes in the reorganization provisions, unequivocally stated that "[t]he principles of section 302 are applicable in testing for dividend equivalency under section 356." H.R. Rep. No. 861, 98th Cong. 2d Sess. 1, 845.[18]

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[16] *See* Rev. Rul. 74-515, 1974-2 C.B. 118; Rev. Rul. 75-83, 1975-1 C.B. 112 ("In making this determination [under section 356(a)(2)] it is appropriate to look to principles developed under section 302 for determining dividend equivalency."); Rev. Rul. 84-114, 1984-2 C.B. 90. Indeed, petitioner himself cautions that his present attack on the court of appeals' reference to section 302 "is not to say that section 302 principles can never have any relevance to the section 356(a)(2) analysis." Br. 30 n.15. Moreover, although petitioner now claims that in the so-called pro-rata situation, there is no need to refer to section 302 principles, the IRS has, indeed, referred to section 302 to measure the dividend effect of boot in those situations, as well. *See* Rev. Rul. 75-83, 1975-1 C.B. 112.

[17] *See Wright v. United States, supra*, 482 F.2d at 605, where the Court noted: "The Commissioner argues that in defining the 'effect of the distribution of a dividend' under § 356(a)(2), the redemption provisions of § 302 should be applied." Petitioner's contention here (Br. 32) that this principle that the two sections should be read in *pari materia* means only that "in both situations it is necessary to look at 'all the facts and circumstances surrounding the distribution' " is nonsensical and is belied by the very cases that have adopted this principle. In any event, petitioner's position requires ignoring the most important of the "facts and circumstances," here, namely, the reorganization context of the exchange.

[18] The amendment made to section 356(a)(2) in 1984 was to state explicitly that the determination of whether a distribution has the effect of a dividend is to be "determined with the application of [the attribution rules of] section 318(a)." This amendment would have little, if any, meaning unless it were assumed that the tests for determining

Such express Congressional recognition of the judicial and administrative interpretation of a statute should be given great weight by the court in determining the meaning of the relevant provisions. *Cf. Lorillard v. Pons*, 434 U.S. 575, 580 (1978); *Slatin v. Stanford Res. Inst.*, 590 F.2d 1292, 1293 (4th Cir. 1979); *Stout v. Hancock*, 146 F.2d 741, 744 (4th Cir. 1944), *cert. denied*, 325 U.S. 850 (1945).

3. The Technical Objections Petitioner Advances For Rejecting Section 302 Are Unsound.

The "major differences" advanced by the petitioner (Br. 34-35, 37-39) for distinguishing the effects of a receipt of cash in a reorganization under section 356(a)(2) from the receipt of cash in a redemption under section 302 are truly distinctions without differences insofar as the issue presented here is concerned.

Petitioner (Br. 34) argues that the approach of the courts below is contrary to the several cases which hold that section 356(a)(2) requires the amount treated as a dividend to be limited to the taxpayer's ratable share of the earnings and profits of the *acquired* corporation. Petitioner (Br. 38) points out that in a redemption exchange under section 302, the gain reduced by the basis of the redeemed shares is subject to tax as a capital gain, while in a reorganization exchange under section 356(a)(2) the entire amount of gain is subject to tax as capital gain. Petitioner also argues (Br. 38) that Mr. Clark's basis in the NL shares he did receive would have been differently calculated had he re-

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dividend equivalency contained in section 302 are applicable. Thus, the tests contained in section 302 require a determination of the shareholder's percentage interest in the corporation before and after the distribution. For purposes of this determination, stock owned by individuals and entities which are related to the shareholder, within the meaning of section 318, are deemed to be owned directly by the shareholder. Unless the section 302 test of a change in ownership interest were to be applied for section 356(a)(2) purposes, there would be no need for an attribution rule to compute such ownership interests.

ceived the quantity of stock contemplated by the one-stock offer. Similarly, petitioner (Br. 39) points out that, if a payment of boot is subject to dividend treatment, the distributee shareholder's "ratable share of earnings and profits" is determined differently under section 356(a)(2) than would be the case under section 302.

However petitioner does not explain why (nor is there any reason why) these distinctions should stand in the way of applying section 302 principles to test for dividend equivalence in a reorganization exchange. Contrary to the petitioner's assertion (Br. 34-35) the court of appeals' holding does not require that the rules of section 302 be used to measure the *amount* of the dividend to the taxpayer. As prior cases have recognized, it is section 356(a)(1) that provides for recognition of gain on what would otherwise be a tax-free transaction and sets the basic rule for determining the *amount* of the gain. Section 356(a)(2) comes into play only to determine the *character* of the income recognized (subject to the gain limitation) by section 356(a)(1). *King Enterprises v. United States*, 418 F.2d 511, 520 (Ct. Cl. 1969). *See* B. Bittker and J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 14.34, at 14-156 (5th ed. 1987). Thus, the special section 356 rules for measuring the amount of a dividend are no reason for ignoring economic reality or the principles of section 302 in determining whether there is a dividend at all.[19]

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[19] Compare section 304(b)(1) with section 304(b)(2)(A). These sections address the treatment of a transaction in which one corporation distributes cash or property to a controlling shareholder in exchange for stock in a second corporation controlled by the same shareholder. Under section 304(b)(1), the determination of whether the distribution is to be treated as a dividend is made with reference to its effect on the shareholder's percentage interest in the second corporation. However, under section 304(b)(2)(A), the amount and source of the dividend is determined with reference to the earnings and profits of the first corporation (and as a result of a 1984 amendment, thereafter with reference to the earnings and profits of the second corporation).

In sum, the rationale for applying the section 302 dividend/exchange standards is sound, and the petitioner's arguments to the contrary do not detract from this conclusion.

C. The Approach of the Courts Below Has Received Widespread Approval.

The approach used by the courts below—both in taking an integrated view of the transaction and in applying the principles of section 302—has been endorsed by the American Bar Association,[20] and recommended for statutory codification by the Staff and the Chairman of the Senate Finance Committee.[21] It is supported by leading scholars and commentators.[22]

In fact, the executive branch has already decided that the approach taken by the courts below and in *Wright* and challenged by petitioner here is acceptable as a matter of tax policy. In 1983, the Treasury Department, through the Office of the Assistant Secretary for Tax Policy, stated that, in the context of the proposed revision of the re-

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[20] *See* ABA Legislative Recommendation 1983-8 (approved by ABA House of Delegates at 1984 Midyear Meeting).

[21] *See* Staff of Senate Comm. on Finance, 98th Cong., 1st Sess., *The Reform and Simplification of the Income Taxation of Corporations*, 63 (S. Prt. 98-95, 1983); Staff of Senate Comm. on Finance, 99th Cong., 1st Sess., *The Subchapter C Revision Act of 1985*, 217-18 (S. Prt. 99-47, 1985); Joint Comm. on Taxation, 99th Cong. 2d Sess., *Tax Reform Proposals in Connection with Committee on Finance Markup*, (JCS 8-86), (1986).

[22] *E.g.*, Levin, Adess, *et al.*, "Boot Distributions in Corporate Reorganizations—Determination of Dividend Equivalency," 30 Tax Lawyer 287, 288 (1976); Golub, " 'Boot' in Reorganizations—The Dividend Equivalency Test of section 356(a)(2)," 58 Taxes 904, 911-13 (1980); Fleming, "Reforming the Tax Treatment of Reorganization Boot," 10 J. Corp. Tax'n 99, 107-110 (1983); Hurley, "Capital Gain Possibilities for Boot in Acquisitive Reorgs Lessened by Shimberg Case," 50 J. of Tax'n. 334, 338 (1979).

organization provisions, "on balance, we do not object to the Staff's recommended approach," which it described as measuring whether boot has the "effect of a dividend" by "look[ing] to the shareholders' reduction in interest as measured *after* the acquisition."[23]

This does not mean, of course, that adoption of this approach must await legislative action. As the discussion above indicates, the approach taken by the courts below and by the Eighth Circuit in *Wright* is the more reasonable, indeed compelling, result under the present statutory framework. It is only because of the IRS's unyielding position that legislative correction, as part of a total revamping of the corporate reorganization area, has recently come under consideration.

II. THE PETITIONER'S HYPOTHESIS OF A PRE-REORGANIZATION DIVIDEND WAS PROPERLY REJECTED.

A. Petitioner's Isolated View is Unrealistic.

Petitioner apparently does not dispute the principle that in testing dividend "effect" under section 356(a)(2), it is necessary to look to the relationships of the distributee shareholders before and after the distribution. *See* Br. 30. But the petitioner would have this Court adopt a wholly artificial view of what relationship existed after the distribution.

Petitioner maintains that the focal point should be the purely notional post-distribution holdings in the *acquired*

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[23] *Reform of Corporate Taxation: Hearing Before the Committee On Finance United States Senate*, 98th Cong. 1st Sess., 24-25 (S. Hrg. 98-556, 1983) (statement of Ronald A. Pearlman) (emphasis in original); *see also* Staff of Senate Comm. on Finance, 99th Cong., 1st Sess., *The Subchapter C Revision Act of 1985*, 3 (S. Prt. 99-47, 1985).

corporation, Basin.[24] Specifically, petitioner's view of the transaction is that, as an unrelated event, before the NL acquisition, Mr. Clark used his control of Basin to require a massive cash distribution by it. Br. 20. Taking such a view requires blindly ignoring practically every relevant fact about the transaction:

First, the cash was not paid in an isolated transaction, leaving Mr. Clark still the sole shareholder of Basin. Rather, it was paid as an integral part of the reorganization in which Basin's identity—and Mr. Clark's position as a sole shareholder—was submerged in the enlarged NL-plus-Basin entity, and in which Mr. Clark's minority shareholder interest in that entity was diminished by reason of having received the cash.[25] Indeed, petitioner's view entails the absurdity of applying section 356(a)(2)—a rule for reorganizations—by steadfastly ignoring the very reorganization transaction that makes the provision applicable.

Second, the initiative for the cash element in the transaction came from NL, not from Mr. Clark, who had previously sought an all-stock deal. The only control Mr. Clark exerted in this regard was his choice of a reduced continuing ownership in the enlarged corporation in exchange for cash. NL made the offer because it wanted to reduce the amount of new stock it issued in the acquisition. These facts show the utter artificiality of the petitioner's reliance on a commentator's "intuition"—his term, adopted by

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[24] The petitioner ridicules the court of appeals for resorting to a "hypothetical scenario" of a redemption. Br. 27 *et seq.* But the petitioner's own analysis resorts to an equally hypothetical, and far less realistic, scenario—the premerger declaration of a dividend by a controlling shareholder as an independent and separable step in the reorganization. Br. 20.

[25] Respondent does not argue, and the courts below did not hold, that dividend treatment is excluded merely by Mr. Clark's transition from being sole shareholder of the acquired company to being a minority shareholder of the enlarged NL entity.

petitioner's brief (Br. 20)—that "what is really going on" when NL offered Mr. Clark the part-cash option was Mr. Clark "making use of [his] last opportunity to withdraw profits from [his] corporation before [he] lose[s] control as a result of dilution by the reorganization." This characterization was expressly rejected by the court of appeals, which concluded that "there is no evidence of . . . a bailout in this case." Pet. App. 10a.[26] The Tax Court reached a similar conclusion that there was "not the slightest evidence that the cash payment was a concealed distribution from Basin." Pet. App. 37a.

Third, the cash was not paid by Basin but by NL. Indeed, Basin had neither cash on hand nor net assets sufficient to pay the cash. The Tax Court found that the amount of cash received by Mr. Clark "was not only far in excess of the accumulated earnings and profits ($2,319,611), but also of the total assets of Basin ($2,758,069)."[27]

Fourth, the extent to which receiving the cash resulted in changing Mr. Clark's relative continuing ownership interest is absolutely clear here: The undisputed testimony supports the trial court's finding that by taking the cash, Mr. Clark reduced his ownership in the continuing enterprise to about 70 percent of what it would otherwise have been.[28] This major change in Mr. Clark's ownership inter-

[26] The Tax Court described petitioner's hypothesis as a "twisted course" that requires "fantasizing" away the reorganization that invokes section 356. Pet. App. 30a.

[27] The Tax Court, accordingly, reached the following illuminating conclusion:

> In fact, only if one takes into account unrealized appreciation in the value of BASIN's assets, including goodwill and/or going concern value, can one possibly arrive at $3,250,000. Such a distribution could only be considered as the equivalent of a complete liquidation of BASIN, which would call for capital gain treatment under *Zenz v. Quinlivan, supra*. Pet. App. 37a.

[28] Petitioners suggest (Br. 34 n.18, 36) that the approach of the courts below creates valuation problems because there may be other cases in which it would be hard to measure the amount by which receipt of boot in such a transaction reduced the stock interest the stockholders of the acquired corporation would otherwise have had. The need to value assets or stock in a reorganization arises frequently in connection with other statutory and judicially engrafted requirements (*e.g.*, requirement that there be continuity of proprietary interest, and, in certain reorganizations, a transfer of substantially all of the properties). *See* Rev. Proc. 77-37, 1977-2 C.B. 568. Moreover, normally, the owners of an acquired corporation will be able to show that they could have received more stock if they had foregone cash. In any case, speculation about the difficulties of proof that might face other taxpayers is no reason to apply an unreasonable and unrealistic analysis in a case where there is no dispute about how much taking the cash diminished the taxpayer's continuing interest.

est, which was produced by his receiving the cash, is the antithesis of the lack of "change in the relative economic interest or right of the shareholder" that this Court has said is the distinctive feature of a dividend.

B. Petitioner Improperly Equates Mr. Clark's Receipt of Cash With a Dividend Effect.

Petitioner leaps from the fact that a pro rata distribution of cash to all shareholders of an ongoing corporation which has earnings and profits would be treated as a dividend to the conclusion that cash boot, at least if distributed to all of an acquired corporation's shareholders, has the "effect" of a dividend. Specifically, petitioner argues (Br. 11) that Mr. Clark "was in precisely the same position after the merger that he would have been in had the amount of Basin's accumulated earnings and profits been distributed to him as a formal dividend [before the merger], rather than as part of the boot received in the reorganization." The Court is told (Br. 19-20) without citation to the record, that "the distribution of such a dividend would have reduced the value of Basin by the amount of the dividend and accordingly reduced the amount of the boot that NL would have given in exchange for Mr. Clark's stock."

This speculation is entirely unsupported by the record, and is, indeed inconsistent with it. Basin did not have the cash—or even the net worth—to pay any such dividend. Basin's value to NL presumably lay, not in its nonexistent accumulation of liquid assets, but in its continuing potential to provide expert, specialized technical services to NL's downhole mining operations; at any rate, that is why NL proposed the acquisition of Basin. J.A. 44.

Petitioner goes further, to observe (Br. 20) that the shareholders of an acquired company "are the ones who earned the profits and allowed them to accumulate . . . rather than distributing them as dividends" and "are also the persons who negotiate the terms of the acquisition . . . including the extent to which there will be payment of boot." On this basis, petitioner argues that "the boot, then, appears to be simply a substitute for the undeclared dividend."

Insofar as it is not dependent on ascribing to the transaction elements of manipulation of which the trial court expressly found "not the slightest evidence," this view would logically require that the cash element in a sale of stock always be treated as a dividend to the extent of accumulated profits.[29] This whole body of theorizing is simply inconsistent with the basic policy of the tax law applicable in 1979, which was to tax liquidation of all or part of a shareholder's interest at lower rates, even though, as a matter of economic theory, the value of what was sold

[29] Of course, petitioner here limits his argument to cases where all shareholders receive proportionate cash boot. However, disproportionate distributions may still be dividends (*see, e.g.*, Rev. Rul. 85-106, 1985-2 C.B. 116), and in a disproportionate distribution to some shareholders of an acquired corporation, those shareholders would have cash which they could have received if disproportionate dividends had been paid earlier. Only by reference to the effect of receiving the cash on their interests in the surviving corporation can the situation be distinguished. Yet that effect, petitioner maintains, must be ignored.

may reflect accumulated profits—and always reflects expected profits.

C. The Distribution Was Not Pro Rata On a Realistic View.

Petitioner endlessly repeats that a pro rata cash distribution to stockholders of a corporation is a dividend, and that is certainly true because a truly pro rata distribution does not affect relative economic interests. The term "pro rata," however, is applicable here only if the distribution in issue is viewed as having been made to Mr. Clark in exchange for, or in respect of, shares in Basin with Basin remaining in existence and Mr. Clark still continuing as its sole shareholder.

The fatal difficulty with describing this distribution as pro rata is that, simultaneously with the distribution, Mr. Clark ceased to be the sole shareholder of Basin and became instead one of many shareholders in NL. The NL shareholders were at the same time also making a transformation from being shareholders only in NL's business to being shareholders in the enlarged NL-Basin combination being created. Viewed in relation to this larger class, which both sets of shareholders were joining as a result of the transaction of which the boot payment was a part, the distribution to Mr. Clark was not pro rata, but disproportionate. Mr. Clark was the only shareholder in this larger class to receive cash, and the cash did not leave untouched his relative economic interest in the larger, newly created corporation; rather it produced a substantial shrinkage in his interest.

D. Petitioner's Approach Is Subject to Manipulation and Abuse.

The rule advanced by petitioner would offer substantial opportunities for manipulation, especially where there was some overlap of ownership between the acquired and acquiring companies.

One example of the potential for such abuse is set out in the Tax Court's opinion. Pet. App. 12a. The example involves a situation where a single shareholder, A, owns 30 of 100 shares of Corporation X, which is worth $100, and holds all 100 shares of Corporation Y, which is also worth $100. Corporation X merges with Corporation Y creating XY corporation, a new company worth $200. As consideration for the merger, Shareholder A receives 110 shares of XY stock plus $20, instead of the 130 shares of XY stock he would have received in an all-stock transaction. The remaining shareholders of Corporation X receive only XY stock. After the reorganization is completed, therefore, A owns 110 of the 180 shares (61 percent) of XY and has $20.

Under petitioner's premerger distribution approach, A would be accorded capital gain treatment for the cash, since the cash would be viewed as having been paid by Corporation X in a non-pro rata redemption of 20 shares of A's Corporation X stock. The effect of the redemption, tested *solely from the standpoint of the shareholdings in Corporation X*, is a reduction of A's percentage interest from 30 percent (30 out of 100) to 13 percent (10 out of 80).[30] Under this Court's decision in *Davis*, as well as under section 302(b)(2), this would be a sufficiently large reduction in A's percentage interest in Corporation X to qualify for exchange treatment.

In contrast, under the integrated approach adopted by the courts below, the effect of the boot distribution would be considered from the standpoint of the overall merger transaction. In point of fact, A gave up a larger interest in the combined corporation (as Mr. Clark did here) in

[30] Even if part of the cash were deemed to come from Corporation Y, A would, on the petitioner's view, remain the only shareholder in X to receive cash, and hence at least part of the distribution would be non-pro rata, unless, of course, petitioner really maintains that any receipt of cash is a dividend.

return for the cash. In an all-stock transaction, A's interest would have been 130 shares or 65 percent of the 200 shares outstanding. Instead, A received $20 and 110, or 61 percent, of the 180 shares outstanding. Under this integrated analysis, since A remains a majority stockholder, the percentage reduction in A's interest would presumably not be substantial or "meaningful" under section 302, and dividend treatment would result.[31] *See, e.g.*, Note, *Boot Distributions in Acquisitive Reorganizations: The Wright-Shimberg Controversy*, 59 S. Cal. L. Rev. 1295 (1980); Levin, Adess, *et al.*, "Boot Distributions in Corporate Reorganizations--Determination of Dividend Equivalency," 30 Tax Lawyer 287, 296-98 (1976).[32]

[31] Moreover, under the integrated analysis, characterization is unaffected by which company is treated (either by the people who arrange the transaction or by the IRS) as paying the cash.

[32] Another possibility for abuse, involving Wall Street arbitragers, has come to light recently, as a result of publicity given to the Tax Court's opinion in this case. Because of the dividends received deduction for corporations (which was 85% through 1986 and is currently 80%, *see* section 243), it is more advantageous for a corporate shareholder to treat a payment from a corporation in which it owns stock as a dividend rather than a payment in exchange for the stock, which is not eligible for the deduction. Wall Street arbitragers purchase stock in a corporation before an acquisition transaction is closed and realize profits on the spread between the market price and the takeover price. If the acquisition is structured as a tax-free reorganization including some cash distribution pro rata to shareholders of the acquired corporation, corporate arbitragers could, under the approach favored by the petitioner, buy stock in the target and treat the boot (up to the amount of their gain on the arbitraging transaction) as a dividend, taxed at a much lower effective rate (after giving effect to the dividends received deduction) than if the boot were treated as capital gain on the transaction. According to a tax partner at one of the national accounting firms, "This [Clark] decision could eliminate many arbs from the takeover game." *See* "Tax Court Decision Could Ruin Risk Arb Biz," Investment Dealers' Dig. (February 17, 1986), 2.

It is worthy of note that although petitioner rejects an integrated analysis on the facts of Mr. Clark's case, he has applied such an analysis

No doubt because of these difficulties in applying petitioner's premerger dividend approach to reorganizations generally, petitioner avoids embracing it in situations involving corporations with common ownership.[33] Br. 31 n.16. It works equally badly in other types of reorganizations (e.g., a merger in which a very large corporation merges into a very small corporation).[34] In the Tax Court, petitioner proposed a five-part threshold test which would have to be satisfied before applying its approach. *See* petitioner's Opening Brief in the Tax Court, p. 27.[35] Far from bolstering petitioner's position, the need (if abuse potentials are to be avoided) to draw complex and uncer-

(relying on *Zenz v. Quinlivan, supra*) to these very similar arbitrage situations in order to deny dividend treatment for the boot. *See* Priv. Ltr. Rul. 8431003 (April 19, 1984); Gen. Couns. Mem. 39290 (Sept. 27, 1984).

[33] In Rev. Rul. 84-114, 1984-2 C.B. 90, the IRS applied the integrated approach (and section 302) to a recapitalization. The ruling was limited to a "situation involving a single corporation," but no rationale is given for the limitation.

[34] Under petitioner's approach, the effect of a boot distribution to a shareholder of one of the parties to an acquisitive reorganization will have drastically different results depending upon which corporation survives the merger. *See*, Levin, Adess, *et al.*, "Boot Distributions in Corporate Reorganizations—Determination of Dividend Equivalency," 30 Tax Lawyer 287, 298 (1976).

Prof. Kyser, on whom petitioner relies heavily, rejects petitioner's approach in common control cases. Kyser, "The Long and Winding Road: Characterization of Boot under Section 356(a)(2)", 39 Tax. L. Rev. 297, 300 (1984).

[35] The five conditions were:

> [1] a small corporation (the "minnow") [is] merged into a large corporation (the "whale"), [2] there [has] been no previous commonality of ownership between the two corporations, [3] the "minnow's" shareholders [receive] cash and stock on a pro rata basis, [4] the "minnow's" shareholders' stock ownership in the "whale" [is] very small vis-a-vis the number of shares outstanding, and [5] the acquired corporation [has] a significant amount of accumulated undistributed earnings and profits.

tain distinctions that are nowhere reflected in the statute adds further support to the conclusion that the only approach that makes sense from a practical and realistic standpoint is the integrated approach adopted by the courts below. When the effect of the boot distribution is considered in the context of the overall transaction, there is no need for such complicated and contortive rules.[36]

E. The Legislative History of Section 356(a)(2) Does Not Support the Petitioner's Position.

Nothing in section 356 itself, nor in its legislative history, suggests a need or intent to adopt the unrealistic definition of "dividend effect" petitioner advocates. The "boot-dividend" rule entered the tax law in 1924, when the predecessor to section 356(a)(2) was enacted. The tax writing committees were apparently concerned about an abuse situation where, to effect a distribution to its shareholders of cash taxed at capital gain rates, a *single* corporation reincorporated in a transaction which qualified as a reorganization.

The only example contained in the 1924 Committee Reports to show "the necessity for this provision" follows that pattern. In the example, the corporation in question

[36] It is true that in virtually all cases where a shareholder of a "minnow," or small, closely held corporation, receives a combination of cash and stock in a "whale," or publicly held corporation, the reduction in ownership interest in the surviving, publicly held corporation attributable to the cash distribution will be "meaningful" and, therefore, will qualify for capital gain treatment. This does not, however, mean that the lower courts' approach here establishes an automatic capital gain rule. Rather capital gain treatment results because, as has been repeatedly recognized by the IRS, even a quite small reduction in the interest of a minority shareholder will generally be a "meaningful reduction" under section 302(b)(1). *See, e.g.*, Rev. Rul. 76-385, 1976-2 C.B. 92. However, as shown in the example discussed above, pp. 29-31, in other situations, the integrated approach will properly yield dividend treatment.

had $50,000 of accumulated earnings and profits which, if distributed "as a dividend to its shareholders" would have been taxed at the full surtax rates. Instead, the corporation formed a subsidiary and transferred its assets and liabilities to the subsidiary (in a transaction which qualified as a reorganization) in return for stock and $50,000, which was then distributed to the corporation's shareholders. After the smoke had cleared, the owners of the corporation still had a continuing 100 percent equity interest in the corporation, but they also now had $50,000 of its accumulated earnings. The Committee Reports analyze the transaction as follows:

> Under the existing law, the $50,000 distributed with the stock of Corporation B would be taxed, not as a dividend, but as a capital gain, subject only to the 12 1/2 percent rate. The effect of such a distribution is obviously the same as if the corporation had declared out as a dividend its $50,000 earnings and profits. [H.R. Rep. No. 179, 68th Cong. 1st Sess., 14-15; *see also*, S. Rep. No. 398, 68th Cong., 1st Sess., 15-16].

The single corporation transaction described in the legislative history would be a dividend under respondent's analysis as much as under petitioner's.

This Court has described this legislative history as "not illuminating." *Commissioner v. Estate of Bedford*, 325 U.S. 283, 290 (1945). Congress clearly did not have two-party, acquisitive reorganizations in mind when it enacted the predecessor to section 356(a)(2). Consideration was not given to the effect of a transfer of boot by an unrelated corporation as partial payment for the stock of the acquired corporation. The court of appeals properly adopted the Tax Court's conclusion that all that can clearly be gleaned from the legislative history is "that the primary objective of Congress was to prevent shareholders from

bailing out earnings and profits at capital gain rates *when in essence the shareholders stood substantially in the same position before the reorganization as they did after the reorganization.*" Pet. App. 10a. (emphasis added).

F. The Decisions of This Court and of Other Courts of Appeals Do Not Compel—or Indeed Support—Petitioner's Position.

Contrary to petitioner's contention (Br. 21), the position advanced by petitioner here is not supported by *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945), nor by a "long and consistent line of court of appeals decisions."

1. Bedford

In *Commissioner v. Estate of Beford*, 325 U.S. 283 (1945), this Court used language that was capable of being read to support an automatic dividend rule in all cases. *Bedford*, however, did not address the issue presented here, nor did it reach the result often ascribed to it. *Bedford* involved a classic earnings bailout which the predecessor of section 356(a)(2) was designed to circumscribe. *See* H. Rep. No. 179, 68th Cong., 1st Sess. 15 (1924). In *Bedford*, a single corporation was reorganized. The preferred shareholders simply exchanged their preferred stock for shares of a new preferred issue (with reduced rights), shares of common stock, and cash. In these circumstances, this Court held that "a distribution, pursuant to a reorganization, of earnings and profits 'has the effect of a distribution of a taxable dividend' within section 112(c)(2)."

This statement by the Court in *Bedford* was viewed as a blanket endorsement of the automatic dividend rule even in factual contexts very different from the one this Court addressed. Rev. Rul. 56-220, 1956-1 C.B. 191. Because of the difficulty of reconciling this approach with the language of the statute, which implies that boot distributed in a reorganization will generally be accorded capital gain

treatment, and will be taxed at ordinary income rates only if it has the effect of a dividend, the approach came under increasing criticism by commentators. *See, e.g.*, Darrel, *The Scope of Commissioner v. Bedford's Estate*, 24 Taxes 266 (1946); Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule*, 20 Tax L. Rev. 573 (1965). The courts and the Internal Revenue Service have now retreated from the automatic dividend reading of *Bedford*. *See e.g.*, *Wright v. United States*, *supra*, at 605; *Shimberg v. United States*, *supra*, at 287; *King Enterprises, Inc. v. United States*, *supra*, at 520; Rev. Rul. 74-515, 1974-2 C.B. 118, 120. This Court has never addressed—in *Bedford* or elsewhere—the situation presented here of cash received in a reorganization involving two previously independent corporations.

2. Court of Appeals Cases

Many of the cases cited by petitioner employ, in one form or the other, an automatic dividend rule.[37] That is, they are based on the assumption—sometimes ascribed to *Bedford*—that in the context of a reorganization, any distribution of cash to shareholders of the acquired corporation is by its very nature to be treated as a distribution of that corporation's earnings and profits. In *Bedford*, this Court characterized the holdings of these earlier cases as follows:

> It has been ruled in a series of cases that where the stock of one corporation was exchanged for the stock of another and cash and then distributed, such distributions out of earnings and profits had the effect of a distribution of a taxable dividend under section 112(c)(2). *Comm'r v. Owens*, 69 F.2d 597; *Comm'r v. Forhan Realty Corp.*, 75 F.2d 268; *Rose v. Little Investment Co.*, 86 F.2d 50; *Love v. Comm'r*, 113 F.2d 236; *Campbell v. United States*, 144 F.2d 177. [325 U.S. at 291]

[37] For example, in *Commissioner v. Owens*, 69 F.2d 597, 598 (5th Cir. 1934), the test for dividend treatment articulated by the court was simply to treat as a dividend "so much of the [cash] as might before consolidating have been declared by [the acquired] corporation as an ordinary dividend out of its profits.

Petitioner's reliance on these older cases, which are consistent with the automatic dividend rule read into *Bedford*, is misplaced. In more recent years, after rejecting an automatic approach, the courts have viewed the dividend effect inquiry under section 356(a)(2) as one which requires an analysis of the effect of the boot distribution on relative stock ownership interests.

The other post-*Bedford* cases cited by petitioner (Br. 22)[38] do not display the consistent pattern he ascribes to them. In *King Enterprises v. United States*, 418 F.2d 511 (Ct. Cl. 1969), the taxpayer sought dividend treatment because it was a corporation eligible for the dividend received deduction, and the IRS did not object. See 418 F.2d at 514, 521. In *Hawkinson v. Commissioner*, 235 F.2d 747 (2d Cir. 1956), the boot consisted of cancellation of indebtedness owed by shareholders to one of the consolidating corporations, with a corresponding reduction in their stock interests relative to the other shareholders. The court in its holding noted that the indebtedness reflected earlier pro rata advances to the stockholders and that the "so-called reduction in interest was in reality a preservation of the economic status quo." 235 F.2d at 751. In *Ross v. United States*, 173 F. Supp. 793 (Ct. Cl. 1959), the Court of Claims applied a "facts and circumstances test" to find that the payment of cash in lieu of fractional shares of the acquiring company had the effect of a dividend. Evi-

[38] Petitioner does not mention another post-*Bedford* case, in addition to *Wright*, which employs a mode of analysis similar to that of the court of appeals here, namely *McDonald v. Commissioner*, 52 T.C. 82 (1969).

dently, the taxpayer did not argue that the resulting (very small) diminution in the continuing interest he would have had if the combined company had issued fractional shares should have barred dividend treatment. He relied instead on the argument (rejected in *Shimberg*) that the transition from being a .45% shareholder of a small acquired bank to a .08% shareholder of the much larger consolidated bank was itself sufficient to bar dividend treatment.[39] In sum, none of these other cases discusses the issue presented here in any systematic way; all turn on their facts—and all reject an "automatic dividend" rule, while *King Enterprises* and *Hawkinson* apply a section 302 analysis.

3. Wright And Shimberg

Once the cases that do not address the issue are set aside, there are only two court of appeals cases—*Wright, supra*, and *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978)—which bear directly on the issue presented here.[40] Petitioner dismisses *Wright* on the ground that it involved commonly controlled corporations; and he refers to *Shimberg* as the case that "capped" the line of court appeals authority supporting his position. Br. 25-26. By contrast, the American Bar Association, the staff of the Senate Finance Committee and even the Treasury Department, as well as most of the commentators that have considered these two cases, have agreed with the court of

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[39] In a later case applying an integrated approach to the fractional share situation, the Fifth Circuit concluded that the transaction should be viewed, in substance, as an issuance of the fractional shares by the surviving corporation followed by a payment of cash by that corporation in redemption of those shares. *See Mills et al. v. Commissioner*, 331 F.2d 321 (5th Cir. 1964). The IRS embraced this result, and the underlying rationale, in Rev. Rul. 66-365, 1966-2 C.B. 116.

[40] *General Housewares Corp. v. United States*, 615 F.2d 1056 (5th Cir. 1980) and a companion case, *Sellers v. United States*, 615 F.2d 1066 (5th Cir. 1980) are Fifth Circuit cases applying *Shimberg*. See note 41, *infra*.

appeals here in endorsing the result reached by the Court in *Wright* and have dismissed *Shimberg* as a sport, based in large part on misapprehension of the rationale for the opinion in *Wright*.

a. The Wright Case

In *Wright*, a note, in the amount of $102,002, was distributed to the taxpayer in connection with a merger (which qualified as a reorganization under section 368(a)(1)(A)) of two corporations in which he owned substantial interests. The purpose and effect of the distribution was to give the taxpayer a smaller interest in the surviving corporation, so that another shareholder and employee of that corporation could receive a correspondingly greater interest. In determining whether the distribution had the effect of a dividend under section 356(a)(2), the Eighth Circuit adopted the approach which was employed by the Tax Court and Fourth Circuit here. The Eighth Circuit viewed the distribution in terms of the overall transaction, held the standards of section 302 to be applicable, and, applied those standards to the distributee shareholder's interest in the surviving corporation under an all-stock transaction with no boot, and under the combined stock and boot transaction. Finding that the distributee shareholder's interest in the surviving corporation was reduced by 23.3 percentage points, the court held that there had been a "meaningful reduction" within the intendment of section 302(b)(1) and, accordingly, that the distribution did not have the effect of a dividend under section 356(a)(2).

Contrary to the petitioner's insinuation here (Br. 25-26) the decision in *Wright* was not based on the fact that the merged corporations were previously under common control. The court stated unequivocally that "we agree with the Commissioner that section 356(a)(2) should be read *in pari materia* with section 302 for the purpose of determining whether a distribution had the effect of a divi-

dend." 482 F.2d at 605. And, as pointed out above, it relied heavily on the principles underlying section 302—namely, that the "redemption provisions make sense only in relation to a corporation that will continue to exist," because those provisions focus on whether the distributee shareholder "has relinquished valuable rights in the future business," relating to "stockownership—to vote, to participate in earnings, and to share in net assets on liquidation." 482 F.2d at 607. Accordingly, the Court rejected as "artificial" viewing the case as involving redemption of the stock of any one of the individual pre-reorganization corporate parties:

> The change in ownership that would be significant due to a redemption would be a change in ownership in Omni, the corporation that would exist after the redemption and would have voting stock, earnings, and assets that would be affected. Therefore, due to the underlying rationale of section 302 and redemptions in general, we determine under the facts of this case that the taxpayer has in effect exchanged Omni stock for the $102,022 note. [482 F.2d at 608]

Thus, contrary to petitioner's attempt to attach a very narrow significance to the holding and rationale of *Wright*, the opinion of the Eighth Circuit is in fact a general rejection of his pre-merger distribution analysis, and a recognition that measuring dividend effect "make[s] sense only in relation to a corporation that will continue to exist." 482 F.2d at 607.

b. The Shimberg Case

In *Shimberg*, a closely held company (LSC) was acquired by a publicly-held company (MGIC) in a merger that qualified as a reorganization under section 368(a)(1)(A). The shareholders of LSC received stock in MGIC and $625,000

in cash. The Fifth Circuit court of appeals held that since the distribution of cash was pro rata to the shareholders of the acquired corporation, it had the effect of a dividend under section 356(a)(2).

Insofar as *Shimberg* is read as endorsing the artificially bifurcated view espoused by the petitioner, it is subject to all the objections outlined above. In particular, it analyzes the transaction in isolation from the overall context of the reorganization, on the basis of "whether the distribution would have been taxed as a dividend if made prior to the reorganization, as if the reorganization had occurred." 577 F.2d at 288. This approach, as explained above, improperly departs from the statutory standard of measuring the "effect" of the exchange as a whole.

Shimberg, moreover, appears to have rejected *Wright* on the basis of an erroneous understanding of its analysis. As both the Tax Court and Fourth Circuit noted in their opinions (Pet. App. 13a, 28a-29a) there is a serious flaw in the statement of the *Wright* holding by both the Fifth Circuit and the District Court that it reversed, and this misunderstanding may have contributed significantly to the holding of the *Shimberg* case. At the trial level in *Shimberg*, the District Court (415 F. Supp. 832 (M.D. Fla. 1976)) had relied on the decision in *Wright* to hold that the distribution to the shareholders of LSC did not have the effect of a dividend. However, the District Court misconstrued *Wright*, assuming that it required merely a comparison of the percentage interests which the acquired corporation's shareholders had owned in the *acquired* corporation prior to the merger to the percentage interests which they received in the *acquiring* corporation as a result of the merger. The District Court therefore concluded that the taxpayer's relinquishment of ownership and control of a small, local company in exchange for a "minuscule percentage of the outstanding stock of a huge, publicly-held corporation [made it] clear that the merger resulted in a radical change and meaningful reduction in the nature

of the [taxpayer's] interest in the continuing business." 415 F. Supp. at 836.

It appears that the Fifth Circuit based its reversal of the lower court's decision largely on the mistaken view that the District Court had properly interpreted and applied the approach adopted by the Court in *Wright*. As the Court below noted here, this is borne out by the Fifth Circuit's finding that

> [a] contrary holding would render section 356(a)(2) virtually meaningless when a large corporation swallows a small one in a reorganization, for there will always be a marked decrease in control by the small corporation's shareholders, unless the same shareholders control both corporations. And, even in that situation, disproportionate ownership—as in Wright—could result in meaningful reduction. [577 F.2d at 288][41]

In fact, as explained above, neither the Eighth Circuit in *Wright*, nor the Fourth Circuit in this case, so held. Under

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[41] As noted by the Tax Court (Pet. App. 28a, n.8) the Fifth Circuit's misunderstanding of the holding in *Wright* is even more clearly evidenced in *General Housewares Corp. v. United States*, 615 F.2d 1056 (5th Cir. 1980). In that case the two shareholders of the acquired corporation had a 2/3 and 1/3 stockownership interest, respectively, in that corporation; and after the acquisition by a publicly held company they had stockownership interests in the surviving company constituting 0.4 percent and 0.2 percent of the outstanding stock of that company. The Fifth Circuit, in discussing the holding of *Wright* stated:

> [h]ere, if the *Wright* test were applicable, we would be concerned with a reduction from a 66-2/3% and 33-1/3% interest in Oliver stock for [the two shareholders] respectively to a 0.4% and 0.2% respective interest in the outstanding USI stock. [615 F.2d at 1066]

In *General Housewares*, as well, the Fifth Circuit thus misinterpreted the holding of *Wright* as requiring a comparison of shareholder interests in the acquired corporation to those in the surviving corporation.

the opinion in *Wright*, as under that of the court of appeals here, the stock interest which the shareholders of the acquired corporation receive in the acquiring corporation as a result of taking cash boot is compared to the stock interest *in that same corporation*, the acquiring corporation, which they would have received under an all-stock transaction.

In sum, the position taken by the court below—and in *Wright*—is fully consistent with the statute, reflects economic reality, and provides a workable and certain standard.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

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